

# LETTER

*from the Executive Director*

This 1999 Annual Report on the Massachusetts Contributory Retirement Systems for Public Employees continues the PERAC tradition of communicating important information to retirement board members, employees, retirees, interested parties, and the general public. We believe that this document provides data that serves as a guidepost to the progress made in the administration of our retirement systems as well as a guide to areas needing improvement.

During 1999, I assumed the post of Executive Director at PERAC. My predecessor, Bob Stalnaker, directed the Commission's activities during its first two and one half years of existence. The format and subjects incorporated in this report reflect Bob's insistence on openness, relevance, and timeliness. For this and his efforts in establishing the Commission we are most thankful. Also, during 1999 we saw the arrival on the Commission of Michael Dirrane in the Investment Expert position.

One of the Commission's initial objectives was to expand the Educational Forums for board members and administrators. Nineteen ninety-nine saw an acceleration in this commitment as Forums were held regarding Completion of the Retirement System Annual Report, Actuarial Basics, Information Technology, the Disability Retirement Process, Investment Basics, and Legal Issues. More than 440 Board members and administrators attended these sessions. The Commission continues to believe that education is the best way in which to assure the professional management of our retirement systems.

Nineteen ninety-nine also saw a year long effort on the part of PERAC, retirement boards, and vendors to ensure that payroll, investment, and other important administrative functions were not disrupted by the advent of the Year 2000. A cooperative effort in monitoring, updating, and testing technology systems enabled a smooth transition to the new millennium.

A project with significance beyond the retirement area was also initiated during the year. In conjunction with the Department of Revenue, the Commission coordinated board activity in enforcing the recent Child Support Enforcement Initiative. That program precludes the receipt of benefits or return of contributions by those who have not met their child support obligation. We can think of no more worthy endeavor and look forward to continued success in assisting to combat a major societal problem.

In the investment area, the Commission issued several Guidelines designed to assist boards in maintaining professional management of assets. These include (1) expediting the ability of boards to participate in follow on venture capital partnerships, (2) permitting modest modification of an investment manager's mandate, and (3) allowing limited use of futures/options for risk control purposes. This continues the Commission's dedication to ensuring that the regulatory environment keeps pace with



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the changing investment world.

This document outlines the status of the retirement systems in relation to several important functions including Actuarial, Investment, Disability/Return to Service, and Audit. In reviewing the Board Profiles, it should be kept in mind that PERAC provides hundreds of formal legal opinions to boards each year, we review thousands of benefit calculations and provide a broad range of services beyond those highlighted in this report.

During 1999, we completed 40 system actuarial valuations, and approved an additional 35 valuations performed by private actuaries. This exemplifies a welcome trend towards more frequent actuarial analysis. In conjunction with that endeavor, data clean up continued for 90 systems and 35 new funding schedules were approved. Following up on our commitment to grant boards greater independence, an additional 14 boards were authorized to use calculation software rather than submit all calculations to PERAC. A total of 25 boards have availed themselves of this authority. In addition, the Actuary met with 16 boards to review valuations, funding schedules, and benefit calculation software. Several roundtables were also held where actuaries, practicing in Massachusetts, exchanged ideas and discussed issues.

The information set forth in the report underscores the spectacular progress made by the systems in improving their financial condition. Ten systems have achieved a funded ratio in excess of 90%. Most systems are at a funded ratio in excess of 70% and only six are funded at a level below 50% and most of these are based on valuations that are at least two years old. This progress has taken place as the responsibility for the cost of COLAs was devolved to the systems and as various improvements such as the use of actuarial value of assets were instituted in actuarial methodology. Other systems have adopted more conservative funding schedules and moved away from the minimum allowable schedule (amortization of unfunded liability until 2028 on a 4.5% annual increasing base). These measures will help to mitigate increases in future appropriation levels in the event that investment return targets are not met in a given year.

We also stress that the boards that have been most successful in funding their plans have not reduced appropriation levels, but rather adopted more conservative measures when asset gains would allow a decrease in the annual appropriation. This is prudent in today's environment and provides flexibility in case of an economic downturn.

In the investment area, 114 exemption applications and 16 supplementary regulations were approved. An internal performance measurement system was developed and ongoing investment related Bulletins were issued throughout the year.

Nineteen ninety-nine saw the major US stock market indices close at new highs after registering their fifth straight year of double-digit returns. The Dow Jones Industrial Average surged 27% and the Standard & Poor 500 rose 21% for the year. NASDAQ recorded an astounding return of 86%, with more than half occurring during the last two months of the year. However, 2000 has seen a pull back in some of these areas.

Nineteen ninety-nine also experienced large differentials in the performance of "growth" and "value" stocks. In the S&P, growth stocks outperformed value stocks by more than 15% while among small cap stocks in the Russell 2000, index growth returned 45% more than value. This explains some of the divergence in the returns of the retirement systems.

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For the first time in five years, world markets outperformed the US as the Morgan Stanley EAFE Index rose 27% due to a strong performance in the Asian/Pacific markets, particularly Japan.

In contrast, bonds suffered their worst year since 1994 and second worst year since 1973. As the Federal Reserve tightened three times to combat inflationary risk, the Lehman Brothers Government/Corporate index declined over 2% for the year. The NCREIF Property Index rose 11% for the year, while the NAREIT Index of publicly traded REITs declined almost 5%.

Finally, Internet related fervor resulted in venture capital being the hottest sector of the 1999 market. Many partnerships with a focus on fostering “new age” corporations registered returns in excess of 100% in 1999 as record amounts of capital flowed into this market and “dot.com” start-ups were awarded market valuations far exceeding those of well established traditional companies,

These developments contributed to an increase in system assets from \$36 billion to over \$40 billion. Composite System total return compared favorably with the results of public pension funds nationally. Asset allocation of our systems with slightly less than 50% committed to equities was similar to that of public funds nationwide. However, as can be seen in this report, performance varied widely among the 107 funds analyzed. The most frequent cause of underperformance was equity portfolios dominated by old economy and value stocks and insufficient exposure to technology and other growth stocks. Early indicators are that a reversal of this situation could be taking place in 2000.

The sharp dichotomy and concentration of returns exhibited in the stock market in 1999 confirm the importance of the principles of asset allocation examined in PERAC’s recent investment education report on the subject. Since it is difficult and risky to predict which areas will do best each year, it is wise to have reasonable exposure to all asset classes and subclasses.

Chapter 306 of the Acts of 1996, the statute that created PERAC, represented a comprehensive effort to assure that the law relating to post retirement employment for disability retirees and return to work by those employees was enforced. In addition, changes were made to facilitate return to work and a Pension Fraud Unit was created.

In 1999, PERAC assisted boards in recovering \$1,316,268 in overpayments made to retirees whose earnings exceeded statutory limits. In the three-year period this amount has totaled \$3,796,176. Over the next 10-15 years it is estimated that this experience will save the state and its cities and towns \$13-20 million in payments.

Also in 1999, as a result of the Commission’s efforts, 28 disability retirees returned to work. This not only enabled those individuals to once again lead productive lives but saved an additional \$534,948 in payments. In the three-year period, 55 retirees have returned to work and this amount has totaled \$912,466. Over the next 10-15 years it is estimated that this experience will save the state and its cities and towns \$5.4-8 million in payments.

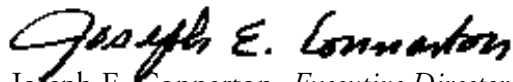
Thus in 1999, PERAC saved the state and its cities and towns \$1,851,216. That three-year experience will result in long term savings of \$18-28 million. These savings will increase each year as PERAC continues its efforts.

In addition, 1999 saw the indictment and conviction of an individual for failing to respond truthfully in filing his Annual Statement of Earnings.

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Over the course of the year, 27 audits of retirement systems were completed. In those, Audit staff identified systems employing an incorrect contribution rate for some employees as well as incorrect methodology in assessing the additional 2% contribution rate on compensation in excess of \$30,000. PERAC also found that a number of city and town treasurers are not performing monthly cash reconciliations as required by law. This issue will be the focus of future efforts by the Commission.

As is recounted herein, great strides have been made in the funding, administration and operation of the Massachusetts Public Pension Systems. Today, most systems are on sound financial footing and employees and retirees can be assured that the boards and administrators are managing the systems in a knowledgeable and professional manner. Credit for this progress must go to the Board Members and staff whose dedication and commitment has formed the base on which improvement has been made. The Commission takes great pride in its contribution to these developments and looks forward to working with the public pension community in building on this exemplary record.



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